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STATE FOR EAP/CM

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TAGS: EAIR ECON HK CH
SUBJECT: CHINESE STATE-OWNED AIRLINE MOVES CLOSER TO CONTROLLING HONG KONG'S CARRIER

Classified By: Acting Deputy Principal Officer Martin Murphy for reasons 1.4 (b) and (d)

¶1. (C) SUMMARY: China's State-owned Air China announced August 17 it would purchase a 12.5% stake in Hong Kong's Cathay Pacific Airways from another Chinese State-Owned Enterprise (SOE), CITIC Pacific, for 6.34 billion Hong Kong Dollars (about USD800 million). This acquisition will bring Air China's stake in Cathay to 29.99%, the second largest after Hong Kong-based Swire Pacific which would also purchase 2% from CITIC and raise its own stake to 41.97%. The deal leaves CITIC with a 2.98% Cathay holding. Transport sector analysts were not surprised by the announcement and described the deal as "inevitable." Given the recent history of cooperation and profit-sharing between the two airlines and cash-strapped CITIC Pacific's ongoing efforts to divest non-core assets, this deal makes more sense than simply the introduction of a third stakeholder. The deal is expected to benefit all three companies but bring little benefit to consumers. In the long-term, Air China may be interested in controlling or merging with Cathay, but doing so might complicate Cathay's ability to serve international routes and would require Swire Pacific to give up one of its "most profitable assets." END SUMMARY

"Inevitable Deal" Brings No Surprises

¶2. (C) Transport sector analysts were not surprised by the announcement. Analyst Kelvin Lau of the Daiwa Institute of Research H.K. Ltd., stated that Air China has expressed interest in Cathay Pacific for several years, and the two airlines have already forged profit-sharing and cargo joint ventures. CITIC Pacific has been under tremendous pressure to divest non-core assets after receiving a financial bail-out package from the Chinese government last year. "CITIC had to sell its stake in the airline and it just so happens that Air China was ready and willing to buy," said Corrine Png, J.P. Morgan's Asia Pacific Head of Equity Research. For this deal to take place, majority stakeholder Swire Pacific had to agree. Given the existing cooperation between Air China and Cathay and pre-established legal measures that guarantee Swire's continued management control of the airline, analysts saw the deal as preferable to other possible scenarios, such as a third party acquiring CITIC's shares.

Everyone a Winner

¶3. (C) Analysts told us all three companies, Air China, CITIC Pacific, and Swire Pacific would benefit. The Air China-Cathay Pacific partnership has aimed at limiting competition between the Beijing and Hong Kong hubs. With an even closer alliance, both airlines win by further complimenting existing networks and by sharing profits from improving air transportation business cycles. Air China

benefits from access to Cathay's higher service standards and business expertise, while Swire gains "brownie points from the Chinese as the deal shows that Swire remains committed to Hong Kong and the greater China region," said Damien Horth, Transport Research Managing Director for UBS Investment Bank. CITIC also benefits by easily divesting a non-core asset to a "friendly" buyer at a premium of 11.84% above Cathay's closing share price on August 14. Analysts see Cathay's new ownership structure as having little impact on the consumer. Pricing should remain unchanged, as Air China, Cathay Pacific, and Dragon Air (Cathay's fully-owned subsidiary) already dominate the profitable Beijing-Hong Kong route.

China Not Marrying Hong Kong's "Flag" Carrier, For Now
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¶4. (C) Horth described Air China and Cathay's relationship prior to this deal as "casually dating" but not yet "engaged." He commented the recent deal "takes the relationship one step closer to marriage but Swire retains the final say," and further that "Swire would not easily relinquish this highly profitable asset any time soon." Although Horth believes an Air China-Cathay Pacific merger is a very long-term possibility, he stated the different operational cultures of the two companies, together with local, regional and global regulatory challenges, all ensure merger talks were not even on their medium-term agenda. Although Hong Kong is a Special Administrative Region of China, it retains autonomy over its air service agreements and air traffic rights. As such, Cathay had to be majority-owned by a national of the "country" (i.e., a Hong Kong resident) or a Hong Kong-registered business to retain "national" airline status and rights. Any move by Air China

for majority ownership would complicate Cathay's international business.

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